Can Europe Afford to Grow Old?

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The answer of course is yes, it has no choice!

- The more relevant questions are:
  - At what standard of living?
  - What role will the public sector play in supporting that standard of living?
  - What policies can improve the way Europe ages in terms of achieving satisfactory economic and social outcomes

AGW projections a useful starting point

- Illustrate the substantial fiscal sustainability challenges for many European economies
- But the sustainability challenge probably greater than portrayed; Projections are optimistic in a number of ways

Three principal points

- An international perspective argues for a policy stance that can be resilient and robust in the face of global structural demographic trends and uncertainties
- Significant policy adjustment required for Europe to "afford to grow old"
- The critical challenge is to catalyze debate within society on the challenges of aging and to facilitate changes in expectation and behavior

1. Start with an international perspective

- Aging not only a European phenomenon
  - Other industrials: US, Japan, Canada
  - Aging Asia: China, Korea, Singapore, HK Taiwan: demographics lagged 15-20 yrs, so at different point of life-cycle; but Asia's growth will slow mid-century
  - Malaysia, Thailand, India, Indonesia to follow
- Global models do not yield clear macroeconomic effects of aging populations
- Most likely see a gradual appreciation of Euro; softening of global interest rates

Other uncertainties may add to need for adjustment

- External competitive pressures from rising Asia
- Climate change: changing temperature, sea level rise, extreme weather events:
  - Consequence for infrastructure? Sectoral adjustments?
- Environmental pressures: water resources
- External security risks: growing populations in potentially insecure regions (Middle East, Africa)
- Commitments for sustained ODA
- Pressures to absorb costly new medical technologies
- International migration pressures

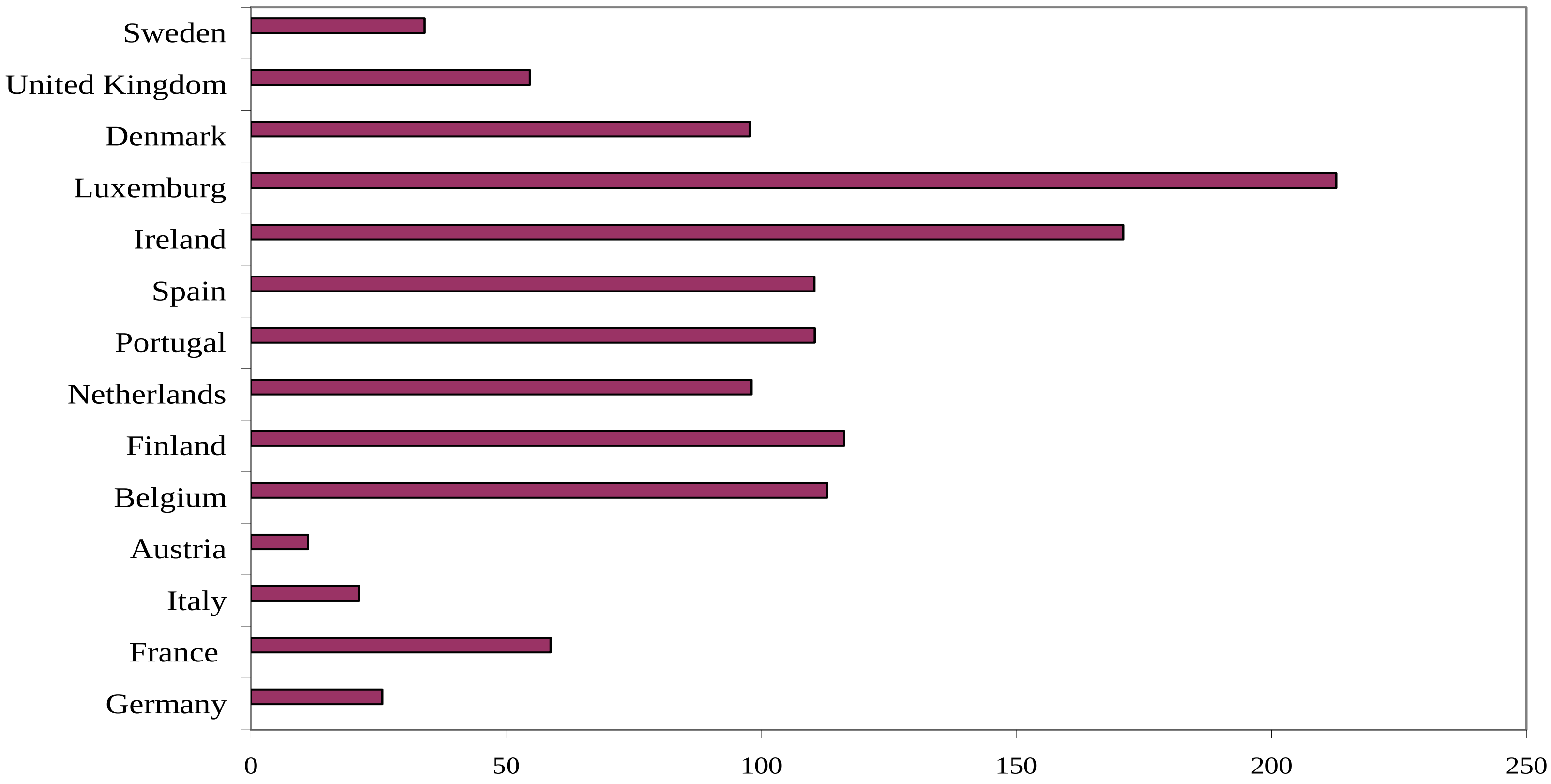
A few obvious implications

- Pressures on fiscal policy will extend beyond dealing with an aging population: argues for a robust and resilient fiscal position that can allow for a response to uncertain shocks
- The external environment may present important opportunities but also obvious risks
  - Obvious example: 2nd and 3rd pillar retirement savings may need to be larger—to achieve target replacement rates--if interest rates are lower in EMs

2. What messages to draw from AWG Report?

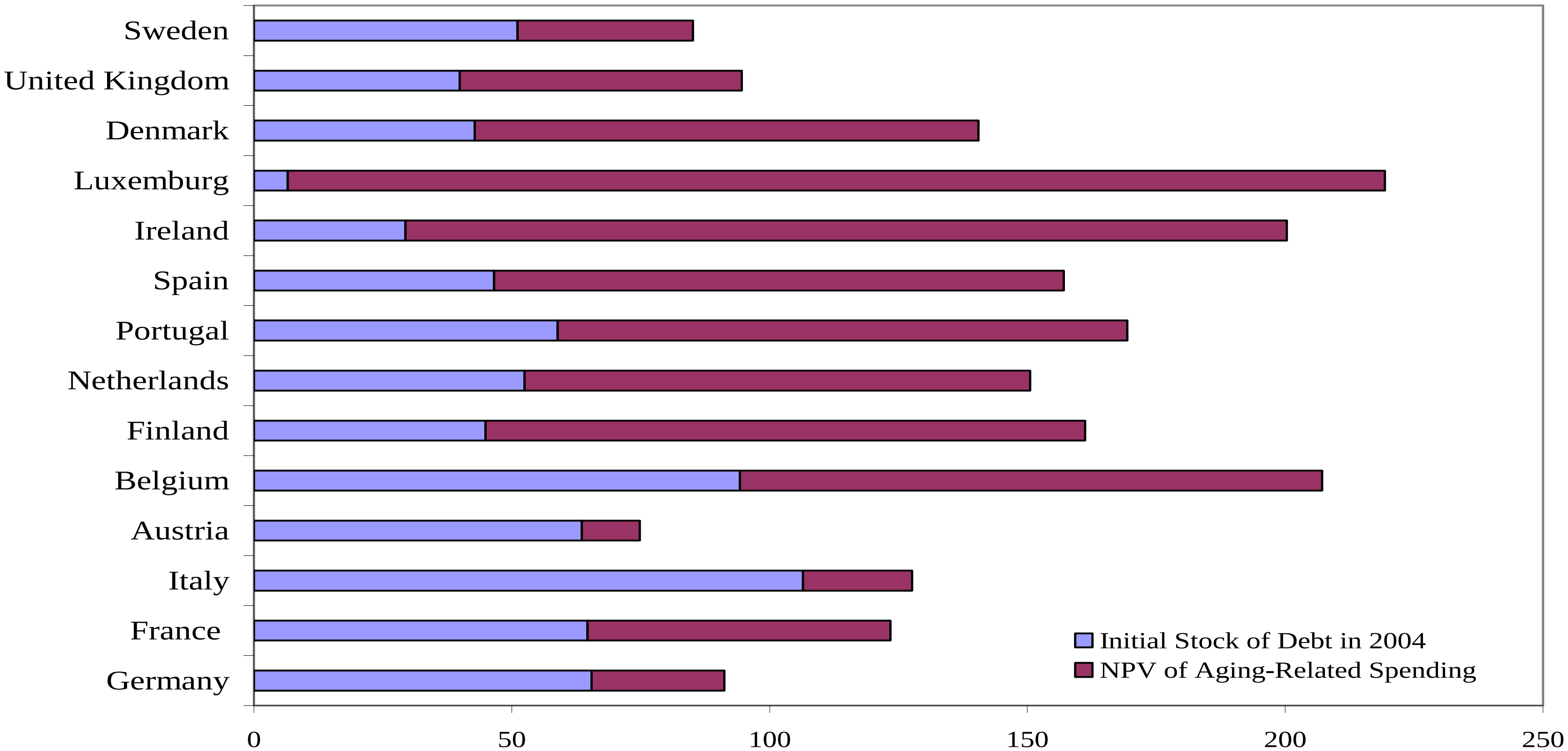
- Level of unfunded “implicit debt” too large
- Actions required NOW to achieve fiscal sustainability involve a BLENDING of:
  - Up-front fiscal adjustment to reduce debt: for some countries, consumption smoothing urgent
  - Not just aging if presently high Debt/GDP and high deficit
  - Phased in benefit rationalization/policy reforms to social insurance—pensions, health, LT care
  - Rebalancing the distribution of risk-bearing as between government and households
  - Choosing fiscal adjustment policies that support rather than weaken growth
    - Caution on raising payroll or income tax rates
    - Caution on risks of undercutting spending on education

Selected EU Countries: Implicit Debt Implied by Additional Age-related Spending (percent of GDP)



Source: NPV of ageing-related spending derived from projections of the Aging Working Group.

Selected EU Countries: Sum of Explicit Public Debt and Implicit Debt Implied by Additional Age-related Spending (percent of GDP)



Source: NPV of ageing-related spending derived from projections of the Aging Working Group; Debt stock in 2004 derived from Ehrostat database.

Fostering a higher GDP level and growth trajectory is critical (but it *won't* solve distributional issue across generations!)

- Given declining labor force, this requires:
  - increased efficiency;
  - greater LF participation,
  - Higher employment rates and hours worked;
  - Robust productivity growth
  - Migration can play a role
- Lisbon Agenda 2 is clear: No need for restating it. Realization of AWG assumptions REQUIRES It. BUT IMPLEMENTATION is KEY
- Worth noting importance of
  - Opening product and services markets to greater competition
  - Getting prices right
  - Enhancing integration of national European financial markets to raise quality of individual and institutional savings
  - Achieving greater regulatory harmonization/deregulation
  - Facilitating labor mobility and more portability of LT savings and retirement vehicles

Chosen policy solution should not excessively compromise the basic intergenerational social insurance pact

- Some delinking of productivity growth and benefit increases inevitable: (perhaps Progressive price indexation?)
- Need to strengthen role of 2nd and 3rd pillars.
- But a solution that excessively reduces the first pillar norm will be problematic, particularly with unchanged contrib rates
- Must still ensure a zero (safety net) pillar that provides basic income support above the poverty level;

Critical to address inefficiency and market failure in medical care sector

- Pressures for rapid growth in medical care costs:
  - income elasticity of demand > 1
  - Aging population
  - DD and SS pressures for high technology adoption in medical care equipment and pharmaceuticals;
  - Duplicative high tech medical infrastructure
- Requires comprehensive global budget rationing; benchmarking to best practices.
- Need limits on extent of private insurance for co- payments and deductibles

Need to deal with significantly divergent fiscal positions within the EU region: some countries in far worse shape than others

- Consequences for functioning of EMU
- Potential for vicious circle of higher tax rates, and reduced benefits, leading to out-migration that shrinks the size of the tax base
- Recognize implications for state-financed PAYG systems of intra-European competition for labor
- Recognize pressures for cross-border mobility for medical care, in response to differential availability of services? Raises issues of eligibility? cross-subsidization?

There is a clear window of opportunity for action

- Acting early reduces the cost of fiscal and private savings adjustment
- Can anticipate resistance to measures as electorate ages
- Act before higher public debt levels lead financial markets to raise risk premium on government borrowing
- What infrastructure required for the 21st century? Will affect new investments
  - may involve downsizing (demographics)
  - Restructuring: energy environment
  - New infrastructure (climate change)

3. The harder challenge is to catalyze the debate and change behavior and expectations!

- First, how to get governments to address problems that lie in the future and are of uncertain magnitude?
- A Long-term fiscal sustainability report may usefully catalyze society to confront and debate such issues
  - A number of countries—Netherlands, UK, Australia, Germany, Switzerland have begun to prepare LT public finance reports
  - Integration of LT factors into fiscal policy stance
  - Important to cost reform proposals!
- Fiscal rules (e.g., debt brakes) can constitute one mechanism to foster fiscal discipline
- Role of independent fiscal councils/commissions

A further challenge: stimulating change in behavior and individual expectations

- The work/retirement balance: the need for retirement age to rise pari passu with increase in "healthy" life expectancy (automatic adjustment?)
- Ensuring incentives exist for higher labor force participation by older age groups/females
- Encourage business toward greater flexibility in employment and wage policy in adapting to elderly work force and supporting female LF participation
- Limiting individual expectations as to what medical care can be publicly guaranteed and financed
- Integrate government policies encouraging labor force participation and providing long-term care options
- Strengthen preventive health program efforts

Shifting of greater risk to households will require strengthened attention to financial issues

- Strengthen financial education and awareness: note significant under-risking in HH balance sheets
- Foster new financial products--raise productivity of savings
- Encourage higher rates of private savings (including mandatory saving schemes; "opt out" approaches to 401K; other tax incentives to increase quality (if not quantity) of savings
- Continue to promote development of balanced *multi-*pillar pension system; Encourage greater risk pooling in private pension savings and long-term care insurance
- Work with LICs and EMs to strengthen the capacity of their financial markets to absorb/allocate capital with high returns

In closing

- Europe *can* afford to grow old.
- Its challenge is to weather its "mid-life crisis," and move ahead resolutely to confront the know policy challenges and obvious uncertainties which lay ahead